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C O N F I D E N T I A L SECTION 01 OF 03 BAGHDAD 001020

SIPDIS

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SUBJECT: CENTRAL BANK - CURRENT POLICIES, FALLING RESERVES,
DOLLAR DEMAND

REF: BAGHDAD 508

Classified By: Acting Economic Counselor Ruth Hall for reasons 1.4(b) and (d)

¶1. (C) Summary: In early April, top Central Bank of Iraq (CBI) officials discussed current CBI policies in separate meetings with Finatt. Senior Advisor Dr. Mudher Salih Kasim listed several reasons for the rising demand for the dollar, which all stemmed from Iraq's growing cash-based economy that uses dollars to purchase large-ticket items, imports and houses. The CBI is monitoring its falling reserves, but believes the situation might improve in June. CBI officials discussed policies that promote the development of private banks and supports the expansion of the Treasury-bill (T-bill) market to non-residents. Officials commented on their struggle to maintain CBI independence from the government and future cooperation with the International Monetary Fund (IMF), which needs to be considered with some "limits and conditions." This cable contains market sensitive information, please protect accordingly. End summary.

Demand for Dollar Grows

¶2. (C) On April 4, CBI Senior Advisor Dr. Mudher Salih Kasim told Finatt that Iraq still remains a cash economy and attributed numerous reasons to the growing dollar demand witnessed in CBI regular foreign exchange auctions. Baghdad's real estate prices continue to climb, with sales conducted in dollars primarily because purchasing homes with Iraqi Dinars is burdensome with the largest Iraqi Dinar denomination equivalent to only a few US dollars. Purchase of automobiles, durable goods, and other imports, importers often require dollars, and high demand for these goods has raised the demand for dollars. As the government spends domestically and the economy grows, the demand for imports boosts demand for foreign exchange for both dollar bank notes and wire transfers.

Banks Stockpiling Dollars

¶3. (C) Banks have begun to stockpile dollars on rumors that the CBI may stop its bank note sales altogether. Some GOI officials were concerned that the auction is being used to whisk funds, including illicit proceeds, out of the country. Dr. Mudher also noted that with the Iraqi dinar no longer appreciating, speculators on the dinar's appreciation over the last year have begun to convert dinars back to dollars and repatriate their profits. Moreover, Jordon had reduced the fee for Iraqis to register as residents to USD 2,500, leading to a spurt in registrations and greater dollar demand.

Inadequate Documentation of Dollar Purchases

¶4. (C) State-owned banks Rafidain and Rasheed, Dr. Mudher

noted, were purchasing huge sums of dollars without providing adequate documentation regarding these purchases. He indicated that these bank note purchases were predominantly for trade with Iran, noting, "The Iranians want dollars in cash. Only dinar (IQD) and dollars are traded at the border, with no demand for Iranian currency. There are some dollar purchases at the Turkey and Jordanian borders, but for the most part these dollar bank notes are going to Iran." Dr. Mudher noted that under pressure from the government, the CBI issued an instruction that no government ministry could seek foreign exchange via the auction, and that banks had to provide documentation of a legitimate trade transaction to participate in the auction. CBI has now also imposed a punitive measure of a five-day restriction on bank note purchases for both Rafidain and Rasheed. On the CBI's purchases for both Rafidain and Rasheed. On the CBI's tougher stand against fraudulent transactions in the foreign exchange auction, Dr. Mudher said, "The hammer of government is still strong."

CBI Will Wait until June to Act on Falling Reserves

15. (C) Both Dr. Mudher and CBI Governor Sinan al-Shabibi told Finatt separately that the CBI will wait until June before they fully understand the direction of CBI foreign exchange reserves. By June, the GOI may have used up all funds that it stockpiled in the Iraqi banking system for budget expenditures and will again have to start selling dollars to CBI. This will allow the CBI to rebuild reserves, assuming that demand does not outstrip the new supply purchased from the MOF. Currently, according to Governor Shabibi, MOF has

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since December not sold any US dollars to the CBI and is attempting to rebuild the DFI, preferring to spend its in-country balances.

Government Funds in Private Banks

16. (C) Dr. Mudher agreed with Finatt on April 4 that the recent Ministry of Finance (MOF) decree to forbid ministries and state-owned enterprises (SOEs) to have accounts in private banks was MOF's effort to marshal its available funds. (Comment: Finatt recommended that MOF require a full accounting of the ownership of all government deposits in detail in order to locate all available funds. End Comment.) While CBI's interest is in aggregated sectoral balances, it is in MOF's interest to locate and account for government funds department by department.

17. (C) On April 8, Dr. Mudher showed Finatt a High Economic Committee April 6 Decree that decided to allow ministries and "self-financing companies" to open bank accounts with private banks without interference from the Trade Bank of Iraq. The notice also included a remark that MOF has reservations against ministries opening bank accounts in private banks. (NOTE: Although this decree offers policy advice and has no legal bearing, having DPM Barham Salih's signature on the Decree is significant. End Note.)

Letters of Credit, New Minimum Capital Requirements

18. (SBU) The High Economic Committee's decree and recommendations of the January Banking Conference refer to the need for the CBI to assess banks' capabilities to undertake Letters of Credit (L/C) business. Dr. Mudher noted all banks are required to bring their statutory capital to IQD 50 billion by the end of June. He mentioned that Kurdistan Bank had already raised its capital to IQD 100 billion; however, CBI needed to take the initiative to identify other banks that were capable of conducting this

business. Governor Shabibi confirmed with Finatt on April 8 that CBI will assess all the private banks and determine which ones are eligible to do L/C transactions.

T-Bills Possible?

¶9. (C) When Finatt asked about the possibility of the GOI opening the T-bill market to non-residents to raise demand for T-bills and create some predictability in the market, Dr. Mudher responded that the CBI supports this approach. However, he would have to look into the appropriate platform and regulations for a secondary market. Dr. Mudher added that he and the Chairman of the Council of Representatives (CoR) Economic Committee had discussed establishing a public debt ceiling instead of requiring, as stipulated under the new budget, that every single T-bill issuance obtain CoR approval (by majority vote). (Comment: A CoR approval for every auction would be absurdly burdensome and inefficient, especially in the current political environment. End Comment.)

Central Bank Independence

¶10. (C) Dr. Mudher revealed that the CBI would like to be more "administratively independent" from the government but is willing to "give some room" on its stance towards lending to the government. (Note: Under law, CBI is prohibited to lend to the government. End Note.) If the laws were amended to allow some lending to the government, he noted, there would have to be some reciprocal arrangement wherein the Government would allow CBI more administrative independence - particularly freedom from the Prime Minister's ability to dismiss the CBI Governor for reasons besides unlawful behavior, for example. Dr. Mudher added that CBI and MOF Qbehavior, for example. Dr. Mudher added that CBI and MOF needed to develop service-level agreements for all CBI activities conducted on behalf of the government; i.e., payments, deposit taking, bill administration, fund administration, and other activities.

¶11. (C) Dr. Mudher commented that the government has pressured CBI to fund some of the 2009 budget with its reserves but Governor Shabibi has resisted. This has endangered Shabibi's future as CBI Governor. However, Governor Shabibi in his later meeting with Finatt said that television commentators were viciously attacking CBI policies but that "things are better now" as opposed to a few weeks ago.

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Future IMF Cooperation

¶12. (C) Governor Shabibi told Finatt that he planned to attend the IMF/ World Bank meetings in the U.S. this spring, and that it is important for Iraq to "have some sort of cooperation with the IMF" as Iraq needs lots of technical assistance. He pointed out that some within the government do not favor another arrangement with the IMF because they felt the previous Stand-By Agreements were too intrusive. He concluded that there should be some "limits and conditions" on any new arrangement Iraq signs with the IMF.
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